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Supreme Court of the United States

FIA CARD SERVICES, N.A., FKA MBNA AMERICA BANK, N.A.,
Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
Respondent.

LANCO, INC.,
Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,
Respondent.

On Petitions for Writ of Certiorari to the West Virginia Supreme Court of Appeals and Supreme Court of New Jersey

BRIEF *AMICI CURIAE* OF COUNCIL ON STATE TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS AND NATIONAL MARINE MANUFACTURERS ASSOCIATION IN SUPPORT OF PETITIONERS

JAN S. AMUNDSON
QUENTIN RIEGEL
NATIONAL ASSOC. OF MANUFACTURERS
1331 Pennsylvania Ave., N.W.
Washington, D.C. 20004-1790
(202) 637-3000

STEPHEN P. KRANZ
Counsel Of Record
DOUGLAS L. LINDHOLM
DIANN L. SMITH
WILLIAM D. PELTZ
BOBBY L. BURGNER
J. HUGH MCKINNON
COUNCIL ON STATE TAXATION
122 C St. N.W., Suite 330
Washington, D.C. 20001
(202) 484-5221

(Additional counsel listed on inside cover)

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20002

JONATHAN S. MASSEY
JONATHAN S. MASSEY, P.C.
7504 Oldchester Rd.
Bethesda, MD 20817
(301) 915-0990

MONITA FONTAINE
NATIONAL MARINE
MANUFACTURERS ASSOC.
444 North Capitol St., N.W.
Suite 645
Washington, D.C. 20001
(202) 737-9761

QUESTION PRESENTED

Whether the Commerce Clause bars a state from imposing income and franchise tax on an out-of-state company engaged in interstate commerce, when that company has no "physical presence" in the state.

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INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici*'s associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations will create significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees – that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers from all 50 states, many with multistate operations. NAM's mission is to enhance U.S. manufacturing competitiveness by shaping a legislative and regulatory environment conducive to economic growth and to increase understanding among policymakers, the media and

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. Written consent of all parties to the filing of this brief has been obtained and filed with the Clerk of this Court.

general public about the vital role of manufacturing to America's economic future and living standards.

National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,600 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37 billion in 2005 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented.

SUMMARY OF ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes.

However, some states are aggressively seeking to increase their tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. The states have adopted a variety of "nexus" standards through judicial, legislative, and administrative action. These standards, which are ill-defined and differ from state to state, have highly burdensome implications for taxpayers doing business in multiple jurisdictions and thus place heavy burdens on interstate commerce. Yet the highest courts of West Virginia, New Jersey, South Carolina, and Ohio have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. State appellate courts have issued similar decisions.

These cases warrant this Court's review not simply because of the conflict among state courts regarding the meaning of the Commerce Clause in the context of corporate income and franchise taxes. Rather, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements. A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there is real economic loss when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce.

The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, the need for this Court's plenary review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than sales and

use taxes. The costs of compliance are much greater, and the threat to interstate commerce is more immediate. The number of potential taxing jurisdictions at the state and local level authorized to impose business activity taxes is double the number imposing sales and use taxes. Certiorari is amply warranted.

ARGUMENT

I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE.

A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability.

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of a use tax on an out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id.* at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. West Virginia has adopted a "significant economic presence" test, which would permit a state to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. New Jersey has held that licensing "intangible property" for use within a state creates an economic "presence" permitting taxation. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g.*, *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio), *cert. denied*, 519 U.S. 810 (1996) ("the physical-presence requirement of *Quill* is not applicable" to state income tax); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C. 1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

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[2] *See also Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-195 (N.C. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002).

[3] *See, e.g.*, Ark. Reg. 1996-3; Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2007); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2007); Directive 96-2 (Mass. Dep't of Revenue July 3, 1996); Minn. Stat. § 290.015(1)(c)(3) (2005); Okla. Admin. Code § 710:50-17-3(a)(9) (2005); Wis. Admin. Code Tax § 2.82(4)9 (2007).

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities, and even whether they are required to pay tax in a jurisdiction at all. "The economic nexus theory raises the possibility of such a steep slippery slope of application that it would be virtually impossible to come up with the necessary benchmarks that would serve as an efficient, fair and definite standard to determine state and local tax jurisdiction and a taxpayer's filing obligation. With so many possible applications, it is also unlikely that the states would be able to form a consensus on the boundaries of nexus." Scott D. Smith and Sharlene Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 2002 STT 174-2, Sept. 9, 2002, at 5-7. For example, a recently proposed bill in New Hampshire would impose a corporate income tax with no guidance as to what activities give rise to economic nexus.[4]

"There are infinite possibilities for establishing nexus when economic/non-physical factors are used as determinants of jurisdiction. Economic nexus is an amorphous concept without clear definitions or boundaries. . . . And, compliance with and administration of a taxing system based on economic nexus is costly and inefficient for both taxpayers and taxing authorities." Smith and Amitay, *supra*, at 2.

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[4] The bill creates a legal standard of "a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state." H.B. 351, 2007 Sess. (N.H. 2007). The definition includes but is not limited to "a group of actions performed by a business organization for the purpose of earning income or profit from such actions and includes every operation which forms a part of, or a step in, the process of earning income or profit from such group of actions." "The actions ordinarily include, but are not limited to, the employment of business assets, the receipt of money, property or other items of value and the incurring or payment of expenses." *Id.*

Accordingly, such uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's plenary review.

B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses.

The abandonment of a physical presence rule will dramatically increase compliance costs. Multistate businesses face the prospect of taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes. A recent Ernst & Young survey found that state and local governments impose over 3,300 business activity taxes.[5] An additional 9,300 U.S. jurisdictions have the power under state law to impose such business taxes but do not currently do so. In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business will have to analyze a long list of issues for every jurisdiction where it has a commercial profile.

1. Return Filing Methods.

At the federal level, there are only two types of income tax returns – separate and consolidated – and taxpayers make an election to file a consolidated return based on carefully identified criteria in extensive regulations. In contrast, the states have numerous types of returns with inconsistent and overlapping names and frequently opaque rules. Further, most of the various types of returns are mandatory, not elective. Some states adopt standard federal consolidated

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[5] "State and Local Jurisdictions Imposing Income, Franchise and Gross Receipts Taxes on Businesses, March 7, 2007" at: http://www.ey.com/global/content.nsf/US/Tax_-_Overview.

reporting concepts. With respect to reporting requirements, 25 states require or allow combined reporting (treating affiliates meeting certain criteria as one taxpayer), and 22 states require or allow separate reporting. 29 states allow or require the filing of consolidated returns that differ in major respects from the federal rules. A cursory list of the issues and variability of state laws regarding the determination of the appropriate type of return includes:

(i) Is combined reporting (including certain affiliated businesses to file as one unit) allowed, prohibited, or elective? Not all states have statues on point, and the issue of a taxpayer's right to file a combined return has been heavily litigated.

(ii) What are the requirements for an affiliate to be included or excluded from the combined report? Does the state require only that the affiliates be unitary? Does the state have some type of additional test such as a requirement that there is some type of distortion in the calculation of a company's income and tax if the calculation is done on a separate return basis? If so, what is considered distortion? Can distortion be rebutted by using the federal income tax rules for determining arm's length pricing for inter-company transactions? If so, does a state adopt all of the federal regulations or does it have its own interpretation of arm's length pricing?

(iii) What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Requirements vary. Further, what does "ownership" mean? Are there beneficial ownership rules? What types of stock are considered in the ownership test – preferred stock, convertible bonds, restricted stock?

(iv) How are pass-through entities treated? Is the pass-through entity included in the combined report if its majority ownership is the combined group? Is only its income allocated to the member included in the tax base or is its total

income included? Does it make a difference if the pass-through entity is a general partnership, limited partnership, limited liability partnership, or real estate investment trust?

(v) Generally, only affiliates involved in a "unitary business" may be included in one combined return. What is the definition of a "unitary business" in any given state – the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test? The latter are sometimes in a statute, sometimes in case law and often consider such issues as whether the affiliates are in the same line of business, the control exerted by the parent corporation, and the sharing of back-office services.

(vi) What types of entities and business may or must be included in a combined return and which must be excluded?[6]

(vii) If a state follows the traditional federal consolidated return rules, are only affiliates that have a nexus (however defined) with the state included in the return, or is the entire federal group included?

2. Filing Requirements and Mechanics.

Once the type of return to be filed is determined, the taxpayer must determine the time frames for filing and paying the taxes, obtaining a refund, or seeking an extension.

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[6] May an insurance company be included with its non-insurance affiliates? Must a company with less than 20% of its property or payroll in the United States be included? Are affiliates in Puerto Rico included? Must foreign entities that do no business in the United States be included? If a foreign entity has income from the U.S. but does not have a permanent establishment in this country, is it included in the combined return with its domestic affiliates? Some state statutes mandate that foreign entities doing business in certain countries be included in a combined return with domestic affiliates. Are new acquisitions included or prohibited? If new acquisitions are not immediately included in the combined return, when are such acquisitions added?

(i) Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

(ii) A taxpayer must determine the type of rules and software that are required for filing the return and paying the tax. Must the return be filed electronically? Must the payment be sent electronically? What happens if there is an error in the submission that is not the taxpayer's fault? What type of confirmation must the taxpayer keep of its electronic submissions?

(iii) What are the deadlines for filing estimated tax payments? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years with respect to estimated payments?

(iv) What are the procedures for amendments and adjustments?[7]

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[7] For example, what are the deadlines for filing an amended return? If a taxpayer has a federal income tax adjustment, when must that adjustment be reported to the state? If such an adjustment is made, and the statute of limitations on the state return would otherwise have expired, may the state examine the entire return or only the issues affected by the federal adjustment? If an amended return includes a refund, does the state have to respond within a certain number of days or is there a "deemed denial" provision? If the taxpayer is under audit, may the refund be filed with the auditor or must an amended return with the refund calculation be filed apart from the audit activity? What is the timing for filing an appeal from a denial of a refund? What is the statute of limitations on audit and assessment versus filing a refund claim? Is the interest rate on overpayments and underpayments the same or different? If a taxpayer overpaid in one year and underpaid in another, is netting allowed? To what judicial or administrative body does an appeal go? Can the taxpayer handle the case itself; may an outside accountant handle the case; or must a lawyer handle the appeal? At what stage are the facts made on the record? Does the body hearing the factual presentation of a case follow the rules of evidence? Can the state appeal an adverse ruling or is it bound by such a ruling?

3. Tax Base Computations and Adjustments.

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, almost all have significant addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules. Issues that must be considered include:

(i) Does the state follow federal depreciation rules? Many states have departed from the federal bonus depreciation in recent years. This means taxpayers must keep at least two sets of calculation on depreciation. If the state varies from federal rules, what happens when an asset subject to different depreciation rules is sold?

(ii) How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Many states do not allow any carryback of NOLs. Further, many states have a shorter carryforward period than the federal rules. Thus, a taxpayer may have many different NOL calculations in many different states, none of which resembles the federal NOL amount.[8]

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[8] Does the state arbitrarily limit the amount of NOLs that can be taken in any one year – through a cap or through a percentage of the total NOLs available? Can state NOLs in a given year exceed those used at the federal level? How are NOLs applied to a group filing a combined return? What happens if the group filing the combined return is a different group than filed a federal consolidated return (which is frequently the case)? Generally, the taxpayer must recalculate a pro forma or "as if" federal return using its state group. How does a state deal with a company entering a combined group with NOL carryovers? How are NOLs allocated among members of a combined group?

(iii) How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? (Generally, the answer is "no"). What percentage of ownership is required to obtain a dividend received deduction? What is the treatment of dividends received from members of a combined group, and of dividends received from a foreign unitary affiliate that is not included in the combined return?

4. Income Apportionment and Allocation.

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However, states now vary the elements included in the formula, their definitions, and their respective weighting. Currently, 9 states still weigh the three factors equally; 17 states double-weight the sales factor; 5 states place a greater weight on the sales factor; 7 states use a single sales factor; and 9 states have different formulas depending on the type of sales or industry (manufacturing, sale of services, etc.). Other issues include:

(i) What items are included in the "property" factor?[9]

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[9] Is property in transit (for example, a desk moving from an office in one state to another) included and if so, to which state is its value assigned? Where is the value of movable property, such as trucks and railcars, assigned? Is extra-territorial property such as satellites included? Is intangible property included (traditionally it has not been, but that is changing, particularly for taxpayers identified as financial institutions)?

(ii) How is property valued? The historic rule is cost basis (with no depreciation), but some states have moved to a fair market value approach.

(iii) What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?

(iv) What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned? Traditionally, they were attributed to the jurisdiction where the majority of the cost of performance in providing the service or intangible was incurred. However some states have adopted a market rule and look to where the customer is, even for sales of services and intangibles. The variation increases the burden on taxpayers.[10]

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[10] If the cost-of-performance rule is required, what types of expenses are included in the "cost" – back office costs, advertising, shipping? Does the cost-of-performance rule require that more than half of the cost be incurred in a single jurisdiction, or is it permissible to assign receipts to the jurisdiction that has a plurality of the costs? May payments made to third parties be included in cost of performance calculation? If so, how does a taxpayer determine where that third party performed the service? If a market rule is required, how is the location of the customer determined? What if the service, such as a computer service, can be accessed by the taxpayer's customers simultaneously at many different sites? What if the intangible property generating the receipt is used in several different places at once – such as a trademark? What if the location of the customer cannot be determined? What if the receipt is from the sale of tangible personal property, and the customer located in another state takes delivery at the taxpayer's warehouse? Does it matter if the customer uses its own truck or a common carrier?

(v) Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model – such as financial institutions, trucking companies, or broadcasting companies? And if so, can businesses with non-standard apportionment formulas be included in a combined report with unitary affiliates using the standard formula?

(vi) When is a taxpayer required to apportion its income among all of the states in which it does business (i.e., business income)? When must it allocate its income from a certain transaction to one state (i.e., non-business income)? What is the definition of business income? While a standard definition has existed for decades in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), many states have not adopted the model Act, and some states have made statutory modifications (such as changing an "or" to an "and"). Some states have abandoned the business/non-business distinction entirely and adopted the nebulous approach of apportioning all income that may constitutionally be apportioned. Do the proceeds from the complete liquidation of a line of business qualify as business or non-business income? Does it matter if such proceeds are reinvested into the remaining business or paid as a dividend to shareholders? What is the definition and scope of a line of business?

(vii) If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters? Is it the state where the majority of the transactions took place leading up to the sale generating the receipt? If property was sold, is it the state in which the property was located?

(viii) What are the statutory rules for applying an apportionment formula that differs from the statutory

formula? UDITPA contains a provision for changing the formula if the standard formula does not accurately reflect where the income was actually earned. Has the state adopted this rule? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available? May the taxpayer exclude one factor? May the taxpayer add items to a factor that are not usually included – such as adding the value of intangible property to the property factor? What is the burden of proof? In some states the burden of proof is preponderance of the evidence while in other states it is clear and convincing evidence.[11]

* * *

By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer must answer these questions in every state and locality in which it conceivably has an economic nexus – a truly daunting task in light of the 12,600 jurisdictions that have the authority to impose a business activity tax. A company may need to plan several different compliance

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[11] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income – such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigations. All of these items carry significant direct costs and also reduce productivity.

scenarios in hundreds or thousands of jurisdictions in order to assess its potential tax liability.

Further, because systems for apportioning and allocating income are not perfect, increasing the number of taxing jurisdictions will exacerbate the risk of multiple taxation. One commentator has found that a credit card company doing business in only three states would pay tax on 133.5% of its revenues.[12] The multiple taxation burdens will only grow more severe as more states apply inconsistent "economic presence" criteria to out-of-state taxpayers.

Without the physical presence rule, businesses will have to monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[13] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

C. Uncertainty Leads To Substantial Opportunity Costs.

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For

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[12] R. Todd Ervin, Comment, *State Taxation Of Financial Institutions: Will Physical Presence Or Economic Presence Win The Day?*, 19 VA. TAX. REV. 515, 530 (2000).

[13] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, Mar. 2002, at 4. For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty caused by departures from the physical presence rule will tend to cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

D. The Impact on Small Businesses Will Be Severe.

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[14] "Consistent with all earlier research, compliance

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[14] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had an average of $35,443 in compliance costs;

costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[15] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

II. ABANDONING THE PHYSICAL PRESENCE RULE WOULD FRUSTRATE THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB), July 13, 2006 ("FIN 48"). FIN 48 provides uniform criteria for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is more likely than not that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

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firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[15] *Id.*

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states will create havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality will be required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. Otherwise, the company will be required to accrue the full amount of any potential tax liability. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. Taxpayers in identical circumstances could reasonably reach different conclusions. As a result, one taxpayer may accrue a 100% reserve of the potential tax liability while another identical taxpayer may reserve little or nothing at all.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

III. THE SAME CONCERNS THAT LED TO CERTIORARI IN *QUILL* SHOULD LEAD TO IT HERE.

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax

rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. *See* Part I-B, *supra*. Without a physical presence rule, companies would need to examine these questions jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use, where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax, *see* note 5, *supra*, is double the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6.

In addition, corporate income taxes are more onerous because, unlike sales and use taxes, they are borne by the taxpayer itself. A sales tax is automatically passed through directly to the customer. An income tax is not.

For all these reasons, the burdens faced by multistate businesses are significantly greater with respect to corporate income taxes than sales and use taxes. The reasons for granting certiorari in *Quill* are even more compelling here.

CONCLUSION

The petitions for writ of certiorari should be granted.

Respectfully submitted,

JAN S. AMUNDSON
QUENTIN RIEGEL
NATIONAL ASSOC. OF
MANUFACTURERS
1331 Pennsylvania Ave., N.W.
Washington, D.C. 20004-1790
(202) 637-3000

STEPHEN P. KRANZ
Counsel Of Record
DOUGLAS L. LINDHOLM
DIANN L. SMITH
WILLIAM L. PELTZ
BOBBY L. BURGNER
J. HUGH MCKINNON
COUNCIL ON STATE TAXATION
122 C St. N.W., Suite 330
Washington, D.C. 20001
(202) 484-5221

JONATHAN S. MASSEY
JONATHAN S. MASSEY, P.C.
7504 Oldchester Rd.
Bethesda, MD 20817
(301) 915-0990

MONITA FONTAINE
NATIONAL MARINE
MANUFACTURERS ASSOC.
444 North Capitol St., N.W.,
Suite 645
Washington, D.C. 20001
(202) 737-9761